

# STATELINE

The Electronic Version of Stateline, the Official Publication of the National Association of State Credit Union Supervisors

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## Thirdly Business Meeting Special Edition March 7-12, 2004

NASCUS conducted separate Regulator board and Credit Union Council board meetings in Salt Lake City, followed by a concurrent meeting of both boards on March 7, 2004 to consider pending matters and take final action on important issues facing the state system.

After receiving reports from NASCUS Chairman Roger W. Little and NASCUS Credit Union Council Chairman Mike Litzau and associated committees concerning policy with regard to federal legislation it was agreed and accepted that NASCUS will:

- Support federal legislation that would substitute a risk-based capital concept for the current NCUA federal PCA/net worth requirement. *(From the Alternative Capital Task Force).*
- Support modifications to the definition of net worth in the Federal Credit Union Act that would include all forms of capital that are consistent with GAAP accounting principles and address potential FASB merger rules. *(From the Alternative Capital Task Force).*
- Continue to support redefining net worth in the Federal Credit Union Act to permit credit unions to issue supplemental capital to improve the safety and soundness of the credit union system and add additional protection for the NCUSIF. *(From the Alternative Capital Task Force).*
- Consider that the process for converting a state-chartered credit union to another financial institutions charter is a matter that should be determined by state law and regulation. *(From the Government Relations Committee.)*

### **Background:**

Since the passage of the Credit Union Membership Access Act (H.R. 1151) in 1998, NASCUS has urged the NCUA and the credit union system in general to acknowledge the need to provide for credit union use of alternative capital in calculating their net worth ratios. Presently, states may authorize their credit unions to use alternative capital, but federal insurance laws and regulations do not recognize that capital in calculating net worth except for corporate credit unions or low-income designated credit unions. As a result, some fast growing credit unions have been forced to turn away members deposits in order to preserve their net worth ratios. Now, the credit union system and the NCUA are increasingly acknowledging the need to consider some form of alternative capital.

## IN OTHER BUSINESS

### Term Limits Ended

Accepting a unanimous recommendation from the NASCUS Credit Union Council Board to end term limits for Council directors, the NASCUS Board voted to ratify the findings of the Bylaws Review Task Force.

The Task Force investigation found that capable board members can be excluded from top leadership posts just as their experience and knowledge reach a peak due to the term limitations. (NASCUS bylaws previously limited Credit Union Council members to two consecutive three-year terms.) This inhibited retention of experienced leadership on the Council Board as new members took time to absorb NASCUS policies, positions and operational procedures as they worked their way up through various roles on the board only to be excluded from the top posts

The Task Force will submit final recommendations on bylaws revisions to the Boards later this year.

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### Date Change for 2005 Annual Conference

It was agreed and accepted that the NASCUS Annual Conference and thirdly business meetings in 2005 will be held in August to avoid conflicts with the heavy schedule of credit union meetings already scheduled for September of that year. This will be a one time rescheduling of the Annual Conference to garner greater attendance and participation. Based on that experience, the Boards will be able to more effectively evaluate prospective dates for future Annual Conferences. *(From the Education Committee.)*

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### Inspector General Meeting



**NCUA Inspector General Herb Yolles,  
Mary Martha Fortney and Deputy IG  
for Audits William DeSarno.**

The NASCUS Executive Committee officials held an initial meeting with NCUAs Inspector General Herb Yolles and William DeSarno, Deputy IG for Audits during the NASCUS Executive Committee in December, 2003 after the announcement that his office will conduct a review of how the NCUA, as the insurer of federally insured state-chartered credit unions, evaluates and relies on the examinations performed by state regulatory authorities. Yolles explained that of the 57 federal government Inspectors General, half are political appointees, while the rest are appointed by their respective agency heads. Yolles falls into the latter category. While I am subject to the general supervision of the NCUA Board, I have a unique dual reporting relationship with the Congress and the NCUA Board., Yolles said. I want to stress that we are operationally

independent from the agency; we are not NCUAs internal auditor, Yolles continued. We independently select the programs we audit, in the same way as we independently decide upon the investigations we undertake. he said.

The OIG conducts objective audits and investigations relating to NCUAs programs and operations, Yolles explained. Established by the Inspector General Act Amendments of 1988, the NCUA Office of Inspector General is a permanent, nonpartisan, and objective unit. Although its budget is determined by the NCUA Board, within that budget the IG independently determines the priorities of the office, hires and employs staff, and contracts for goods and services under its own statutory authority. Since its establishment in 1989, the NCUA OIG is required by statute to issue semiannual reports to the Board and to Congress. These reports are available on the OIG web site at [www.ncua.gov/oig](http://www.ncua.gov/oig).

Among NASCUS concerns are the OIGs planned audit of NCUAs role in the examinations of federally insured, state charter credit unions, based on risks to the NCUSIF, said NASCUS President and CEO Mary Martha Fortney. Section 201 of the Federal Credit Union Act requires that the agency use state examination reports to the maximum extent feasible, she said.

NASCUS position is that NCUAs treatment of safety and soundness and insurance related costs as synonymous does a disservice to state regulators and state charter CUs, finally posing a threat to the dual chartering system. There should be a separation of the agencys insurance and chartering authority, as it constitutes a conflict of interest and enables the agency to subsidize the supervision of federal CUs through the Overhead Transfer rate.

We are not looking at the Overhead Transfer Rate (OTR) now, said Yolles. That is outside the scope of the audit. One of the things we are very concerned about is what I call scope creep where an original intention expands beyond the envisioned parameters. While the OTR may be on our plate some day, its not now. Right now, its about how the state program is accomplished.

We hear what youre saying, emphasized Yolles. Your examiners dont switch hats. But this is how an audit works; we need documentation, we need facts, we need examples. We cant do specific fieldwork in every state. We cant interview 47 separate state regulators.

The IG will survey regulators and examiners, he allowed, and will look at agreements with NCUA Regional Directors. It will also take into consideration the role and function of the FDIC (which is conducting a similar audit) and is purely an insurer.

After the information gathering phase, the IG will develop a scope and methodology, Yolles said, but it may not entail doing a survey of SSAs.

Part of our mission is to evaluate how well NCUA is carrying out its responsibilities . If all we did was to look to NCUA employees, we might not see the complete picture. Yolles concluded.

To help define the scope of the study, the IG met with the NASCUS Regulator Board in Salt Lake City to help define the scope of the study and raised several questions pertaining to the study. They urged the IG to expand the review to include the reliance on federal credit union examinations and to more fully develop the criteria against which performance will be evaluated. At issue is the IGs exclusion of the NCUSIFs spending from the study. It is anticipated that the dialogue between the IG and NASCUS will continue as the study progresses.

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# Emerging Issues Discussed

The Boards considered both the proposed FASB account principles for mergers of mutuals (which would include credit unions) and the prospective haircut in net worth that could result if purchase accounting rules were to apply to such mergers. If FASB does not grant relief to credit unions in their forthcoming accounting rules, it may require an amendment to the Federal Credit Union Act to rectify the situation.

## **Background:**

*FASB Statements 141 and 142 potentially will severely restrict the ability of credit unions to merge within the constraints of PCA. FASB is recommending replacing pooling method accounting for the merger of mutuals with a purchase method accounting. The purchase method accounting would cause a drop in the surviving credit unions net worth because after a merger, assets would increase, but the capital of the credit union being merged into the survivor would be booked differently on the balance sheet, effectively reducing the surviving credit unions net worth ratio*

*NASCUS has worked diligently to alert FASB to the consequences of this proposed change. However, FASB has indicated that credit unions may need to seek legislative remedy for their concerns. The problem is that HR 1151 defines capital as retained earnings and in the case of the FASB accounting changes, the capital of the merged credit union is not retained earnings. A legislative change would be required to define capital to include the fair market capitalization resulting from the merger of two mutual institutions*

Re: FASB, the Council Board also discussed the need to permit credit unions to assess prepayment penalties on real property loans so that participations on these loans would be more acceptable in the secondary market.

The Boards received an update on the tentative schedule and outlook for the pending Regulatory Relief bill that has been reported out of the House Financial Services Committee and the recently introduced Credit Union Regulatory Improvements Act (CURIA).

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## **State CU Regulators Supervising Privately Insured Credit Unions Seek Cooperative Working Relationship with FinCEN and FTC**

The NASCUS Alternative Share Insurance Task Force met to discuss regulation of privately insured credit unions, including Patriot Act compliance and Federal Trade Commission (FTC) oversight. The NASCUS Alternative Share Insurance Task Force voted to reach out to FTC to help coordinate its development and enforcement of the disclosure regulations.

### Background:

*As part of the ongoing effort to prevent money laundering and the use of financial service providers by terrorists, the USA Patriot Act authorizes the Financial Crimes Enforcement Network (FinCEN) to search records of financial transactions for activities of particular individuals identified as suspicious persons. In February of this year, NASCUS hosted a conference call between FinCEN and the state regulatory agencies supervising privately insured credit unions to discuss issues unique to those credit unions compliance with the Patriot Act. Following up on that call, the Task Force voted to develop procedures for facilitating an ongoing dialogue between state regulators and FinCEN. This dialogue will help privately insured credit unions and their regulators comply with FinCEN information requests and help safeguard credit unions from exploitation by terrorist organizations.*

*The FTC has federal oversight of privately insured credit unions disclosure notices to their members of the lack of federal insurance of share deposits. In its omnibus Study of credit unions published in Fall, 2003, the General Accounting Office (GAO) supported Congressional funding for FTCs oversight of privately insured credit unions share insurance notifications. In November, 2003, NASCUS wrote in support of GAOs recommendation that FTC coordinate with state regulators to ensure that privately insured credit unions meet the disclosure requirements*

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## Strategic Challenges

The Joint Boards discussed separately and concurrently the major threats and challenges that may impact the state-chartered credit union system. These include:

- The announcement by the Chairman of the House Ways and Means Committee of his intention to hold hearings on credit union exemption from federal income taxes.
- The threat by the IRS of imposing the Unrelated Business Income Tax (UBIT) on state-chartered credit unions. *(Actions taken to date and strategy developed by the coalition of CUNA, NASCUS, AACUL, ACCU, NAFCU and CUNA Mutual to respond to the IRS imposing UBIT on state-chartered credit unions was reviewed and considered.)*
- The possible imposition of UBIT on corporate credit unions. *(There are indications that some IRS officials would like to apply UBIT broadly to corporate credit unions on the grounds that, for tax purposes, they are not like natural person credit union organizations.)*
- Attempts by states, often with the assistance of credit union competitors, to impose new or additional taxes on state-chartered credit unions.

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## Strategic Targets

The joint Boards also reviewed the four long-term NASCUS Strategic Targets. They are:

- Expanding the NCUA Board to include one member who has had state credit union regulatory experience.

- Reforming the NCUA Overhead Transfer methodology. The Boards reviewed actions taken to date to build support for the NASCUS plan to separate internally NCUAs federal regulatory and share insurance functions. The Boards stressed the need for NASCUS to educate the state leagues and the entire credit union community about how the current NCUA organization results in a subsidy of federal credit union supervision and examination by the NCUSIF.

### **Background:**

*State-chartered credit unions comprise over 40% of the users of the credit union share insurance fund. NASCUS has long believed that the interests of state-chartered credit unions and state credit union regulators are not being adequately represented in the administration of the NCUSIF. In November 2003, NASCUS published a proposal for reorganizing the NCUA to divide their chartering and regulatory authority from their administration of the share insurance fund. (The published study is available in pdf format at [www.nascus.org](http://www.nascus.org)).*

- Alternative Capital. The Boards reviewed the momentum that is building within the credit union system with regard to alternative capital reforms.
- Alternative Share Insurance. The Boards discussed the importance of preserving state authority that allow non-federal share insurance options for credit unions.

## **Emerging Risks Seminar**



**From back to front, left to right are: Chuck O'Connor, Mike DeCarlo, Tim Blase, Tammi Latture, Gavin Gee, Jim Forney, Shaun Berrett, Denise Townsend, Ray Alegria, Rob Rusch, Robb Kerry, Peggy Sabatier, Claudia Garcia, Julie Bustillos, Lynne Himeda, Donna Metcalfe, Phil Aycok, Larry Chandler, Laura Nyguen, Debbie Franco, Todd Willoughby, Beverly Wharton, Sharon Whiddon, Rita Roach, Greg Perry, and Barbara Franco.**

NASCUS held its 8th annual Assessing Emerging Risks Seminar in conjunction with the NASCUS/NCUAs state regulators conference in Salt Lake City. The Seminar has been heralded a tremendous success by attendees for its valuable insights to managing risks. For a detailed report of the Seminar go to: ([www.nascus.org/home\\_emerging\\_risks.shtm](http://www.nascus.org/home_emerging_risks.shtm))



*Enjoying a bit of networking time are: Beverly Wharton, Laura Nyguen, Bob Fleury, Julie Bustillos, Claudia Garcia, Peggy Sabatier, Lynne Himeda and Tammi Latture.*

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## NASCUS/NCUA State Regulators Conference



*Deborah Matz, Dennis Dollar, JoAnn Johnson, and Roger W. Little*

During the conference, Chairman Little presented California DFI Deputy Commissioner for Credit Unions Beth Dooley with the NASCUS re-accreditation certificate earned by the agency after meeting/exceeding standards in six areas of examination. For details go to: ([www.nascus.org/California\\_earns\\_nascus\\_re-accreditation.shtm](http://www.nascus.org/California_earns_nascus_re-accreditation.shtm))



*Chairman Roger Little presents accreditation certificate to Beth Dooley of California's DFI.*

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# Check Fraud, Lax Indirect Lending Policies Create Greater Risks for Credit Unions

A dramatic rise in check fraud and inadequate board policies and oversight for indirect lending programs pose new and serious risks to credit unions, said Marc Krasnick, leader of CUNA Mutual Groups Credit Union Protection Solutions Group.

Krasnick, CUNA Mutual senior vice president, discussed these risks and ways to avoid them with state credit union regulators attending the NASCUS Assessing Emerging Risks Seminar, March 9, in Salt Lake City.

Check fraud has never been more prevalent in the U.S., and its costing financial institutions between \$12 billion to \$16 billion per year, said Krasnick. Compare that to 20 years ago when financial institutions were losing only slightly more than \$1 million to check fraud.

CUNA Mutual estimates credit unions suffered more than 15,700 check fraud losses in 2003, totaling \$45.7 million. "This is a big deal. Regardless of size, credit unions are seriously at risk to this rapidly increasing crime," added Krasnick.



Marc Krasnick

High-quality, low-cost technology is among several factors contributing to the escalation of check fraud. Others include:

- Increased access to customer information
- Regulatory changes, such as Regulation CC
- More organized and sophisticated crime groups
- Lack of check holds due to increased focus on member service and convenience
- High levels of staff turnover

Fraud perpetrated by new members poses a particular threat. "Approximately 40 percent of check fraud losses occur within the first six months of new membership. It's especially important for credit unions to put extended holds on new-member accounts. This will go a long way toward curbing the problem," he said.

Combining sound risk management practices and new technology helps stem fraud, said Krasnick. CUNA Mutual provides its credit union Bond policyholders with several check fraud education tools, including its Check Fraud CD-ROM teller training tool, online Protection Resource Center, and one-on-one risk management evaluations and training. Credit unions also can protect themselves by following these steps:

- Develop a loss-control program
- Educate staff

- Utilize check holds on counter deposits
- Place check holds on ATM deposits

In addition to implementing prudent risk management procedures, Krasnick urged credit unions to consider using innovative fraud-fighting technology available through verification services, such as Primary Payment Systems (PPS). Last July, CUNA Mutual partnered with PPS, a recognized fraud prevention leader. Krasnick said PPS's suite of technology solutions offer a strong complement to CUNA Mutuals risk management efforts.

### ***Indirect Lending Spike Creates Additional Challenges***

From 2002 to 2003, the number of indirect loans granted by U.S. credit unions increased 29.3 percent to 1.44 million. Growth of these third-party loan arrangements is helping credit unions generate more revenue and increase loan volume while providing members with convenient one-stop, point-of-purchase financing. However, they also are creating compliance, operations and fraud risks, which expose credit unions to losses that can negatively impact business results, said Krasnick.

Consequently, many credit unions are struggling with their indirect lending programs. Credit unions fixated on increasing revenue sometimes find growth problematic as delinquencies surface later. Collection resources are often inadequate, which compounds the problem. If it looks almost too good to be true, it probably is, said Krasnick.

Credit union staff assigned to the indirect lending function often doesn't receive adequate training about the program's pitfalls, or they are overwhelmed by the volume and seek shortcuts that erode loan quality, he added.

Other problems arise from incompetent or unscrupulous auto dealers. Delinquency, charge-offs and paper quality should be tracked by each dealer. One bad apple can spoil the whole program, said Krasnick.

CUNA Mutual recommends credit union boards of directors and management avoid these pitfalls by developing and approving sound written policies covering all indirect lending processes. In addition, timely and accurate reports are vital for the board and management to monitor indirect loans. Reports should break out delinquency stats by dealership, member name, tier, credit score and loan amount.

Indirect lending can be a very positive program for credit unions, but the key to its success is to have clearly-established policies and ensure the program is managed closely and staffed properly. While risks cannot be totally eliminated, CUNA Mutual is committed to working with credit unions to help them balance their risks while providing good member services, said Krasnick.

*Contributed by Philip A. Tschudy, Manager of Media Relations, CUNA Mutual Group*

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**We hope you enjoyed this special edition of Stateline!**

